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Properly Drafted Construction Contracts Can Limit Development Risks

By Scott R. Fradin

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Construction is a risky endeavor. Most experienced investors, developers and owners know that any project can encounter problems, many of which result in disputes, litigation, and financial losses. However, through the careful crafting of contractual provisions, it is possible to avoid or mitigate such risks at all stages of development.

All too often, what seems like a dream project can go south in a matter of days. Consider this scenario: At the outset, the market is hot, the pro forma looks great, and the construction lenders are lining up to provide funding. The architect and contractor both come highly recommended and have significant experience on similar projects. The contractor provides the owner with the contractor's "standard" agreement and the owner signs it without hesitation. Things are going so well that even before the first shovel hits the dirt, the owner has leased 90 percent of the building. Construction starts without a hitch and after the first few months, the contractor indicates that the project is under budget and ahead of schedule.

Then the problems begin. The issues are small at first. A few minor errors in the dimensions of the foundation result in some rework. Then the troubles begin to escalate. An underground storage tank is discovered, requiring review by the EPA and, as a result, the site work stops. Then the owner finds that there is an error in the structural drawings that requires the contractor to re-fabricate some steel. Both the

architect and the contractor inform the owner that the impact to the project, in terms of cost and time, will be minimal. Then the contractor indicates that there will be an eight-week delay in the project schedule, and, due to the escalation in the cost of steel, the "small" impact will now cost more than \$100,000.

As the mess further unfolds, the owner learns that at the time the contractor undertook the project, he was in financial distress as the result of an earlier project, and that he has been diverting funds from the owner's project to cover past obligations. Subcontractors begin to record liens against the project. The lender receives notice of the subcontractors' liens, stops funding the construction loan and declares the owner in default. Without payment, the subcontractors refuse to continue working and the project grinds to a halt.

With no construction progress, the building tenants begin to cancel their leases and by the time the owner secures financing to restart the project, the market has bottomed out and he is left with a building that is 90 percent vacant. The dream project has turned into a nightmare.

Given the magnitude of the losses the owner has suffered and the impending lawsuits by the contractor, the subcontractors, and the lender, the only real choice is to prepare for litigation. As the contract documents are assembled for review by the owner's attorney, the owner realizes that the "standard" contract provides him with little, if any, protection from this disaster.

LITIGATION AVOIDANCE

A well-drafted construction contract can be an effective means of avoiding litigation, but only if it manages both risks and expectations. Most people readily understand the concept of risk management. After all, it is human nature to avoid risks and, for the most part, the contract negotiation process is one in which each party attempts to shift risk to the other. Unfortunately, managing expectations (*i.e.*, expressing to the other party exactly what to expect under the contract) is rarely the focus. But, for a contract to be a truly effective litigation avoidance tool, it must also deal with expectations. A contract that addresses both issues will allow the contractor to better determine—in the event of a dispute—whether he has a viable claim against the owner. If the contract has been carefully drafted to protect the owner, the contractor will hopefully understand that the contract bars his claim and choose not to bring suit.

One of the most effective litigation avoidance tools is the “step mediation” provision. Unlike a typical mediation provision, which usually involves attorneys and a neutral mediator, step mediation calls for project representatives themselves to meet first and discuss the dispute in an effort to avoid legal action. If a resolution cannot be reached at this level, then the discussions are elevated to senior officers of the companies involved. The advantage of this process lies in the fact that these negotiations remain between business people—those who have a vested interest in avoiding litigation and resolving the situation in the most economical way possible.

Another effective clause is the “notice of claim” provision, which requires that a claimant provide the other party to the contract with written notice of a claim within a certain period of time after the claim arises. While a party’s failure to comply with this provision will not necessarily bar a claim, the fact that the obligation is expressly set forth in the contract makes it more likely that the parties will comply. In many cases, the sooner both parties are aware of a claim, the greater the likelihood it will be resolved without litigation.

A third tactic for avoiding litigation is the incorporation of a “liquidated damages” provision, which allows the owner, at contract inception, to fix the amount of his damages as the result of a contractor delay. For example, a liquidated damages provision may provide that the contractor will pay the owner \$500 for every day the contractor delays substantial completion beyond the scheduled date. This type of provision is typically associated with construction projects that have sensitive time deadlines, *e.g.*, schools, manufacturing plants and commercial properties.

It is critical, however, to recognize that this type of provision is upheld only if the actual damages would have been extremely difficult to ascertain and the amount of the liquidated damages is reasonable. Generally, a court will not enforce a liquidated damages provision that is intended to serve as a penalty, or where the damage amount far exceeds the amount of damages the parties would have reasonably forecasted at the time of contracting.

In addition to using these claim-resolution tools to avoid litigation, other provisions allowing for “claim preclusion” are effective. A good example of a claim preclusion tool is the “no damages for delay” provision. As its name suggests, this type of clause essentially states that the contractor will not be entitled to monetary damages in the event of a delay. These provisions are often coupled with a statement that the contractor’s sole remedy for delays not caused by the contractor will be an extension of the substantial completion date. Although there are some legal exceptions that allow a contractor to escape the “no damages for delay” provision, courts generally find that this type of clause is valid.

A similar claim preclusion tool is the “claim waiver.” This type of clause is most commonly associated with provisions allowing the contractor additional compensation for changes in the work, *i.e.*, change orders. Typically, in a claim waiver provision, the contractor acknowledges that any executed change orders constitute full compensation for all delays, disruptions, inefficiencies and other similar costs associated with the change in the work.

This prevents the contractor from later claiming that the change order compensated him only for the direct costs associated with the change (labor and material) and not the indirect costs (delays and disruptions). Some provisions go even further and stipulate that by executing the change order, the contractor waives all claims encountered through the date of the change order, regardless of whether the claim is related to the change in the work.

Finally, one of the more important claim preclusion tools is the “differing site condition” provision. According to common law, the contractor generally assumes the risk that the condition of the site will differ from that shown on the plans and specifications. However, any reputable contractor will insist on a contract provision setting forth his right to receive additional compensation if he encounters a differing site condition. While this type of provision is conceptually fair, the breadth of what constitutes a compensable differing site condition is open to debate.

Most differing site condition provisions will stipulate that the contractor is entitled to compensation only if the condition differs materially from the condition shown on the plans or if the condition is of an unusual nature and differs materially from those ordinarily encountered and generally recognized as inherent in the work. The standard provision does not place much risk on the contractor at all. Thus, in order for an owner to better insulate itself from claims for differing site conditions, the provision should be modified to shift greater responsibility upon the contractor for investigating and discovering concealed conditions. For example, an owner may want to consider limiting the contractor's right to recover for a concealed condition by requiring that the contractor review public records provided by underground utility reporting agencies and public records showing prior uses of the site.

REDUCTION OF FINANCIAL LIABILITY

Even the best contract does not preclude the prospect of litigation or significant financial impact should a project go awry. Therefore, in addition to the provisions designed to avoid litigation, a good contract will provide contractual mechanisms that can reduce an owner's financial liability.

First, the contract can include a provision that obligates the contractor to provide payment and performance bonds. These bonds will, essentially, ensure that the contractor will meet his payment obligations and will complete the construction. In the event the contractor does not meet these commitments, the surety will step in and fulfill the contractor's obligations.

The ability of a contractor to obtain a bond is predicated on his financial condition. If the contractor does not have a solid balance sheet and is unable to provide a bond, the owner should consider a contractual provision obligating the contractor to require certain major trades—such as concrete and structural steel—to provide bonds. Typically, larger subcontractors will be bondable and this provision will ensure that those trades have the capacity to fulfill their obligations.

Indemnification and defense provisions are also essential tools for reducing financial liability. This is particularly true on construction projects where the risk of worker injury is high, along with the likelihood that legal action could result from such injuries. The concept of indemnification is relatively simple: The contractor agrees that if the owner suffers a loss as the result of a contractor's action or failure

to act, then the contractor will compensate, *i.e.*, indemnify, the owner for any amount the owner is required to pay. When this obligation is coupled with a provision requiring the contractor to also defend the owner in a lawsuit, the owner can, essentially, insulate himself from financial disaster. Many states have anti-indemnity statutes that apply to construction. These statutes render contract provisions indemnifying the owner from his own negligence void and unenforceable.

Closely related to the indemnification provision are clauses that require the contractor to waive his right to limited liability under the states' workers' compensation laws. Without this waiver, the contractor's liability for an injury to one of his employees is limited by statute, thereby leaving other potentially liable parties, such as the owner, at risk for being required to cover the difference between the amount a jury awards the injured employee and the amount paid through workers' compensation insurance. However, by requiring the contractor to waive this statutory limit of liability, the owner will be able to avoid this potential exposure.

Similarly, it is virtually certain that any construction contract will have a section devoted to insurance. What that section may be missing, however, are provisions that are essential to limiting the owner's financial liability. One such provision obligates that the contractor name the owner as an "additional insured" under the contractor's general liability insurance, allowing the owner to make a claim—such as for a jobsite injury to an employee of the contractor or a subcontractor—under the contractor's insurance and avoid having to tender the claim to his own insurance company.

A provision that has become more commonplace in construction agreements is the "no recourse/non-liability" provision, which typically contains two express limitations on a contractor's right to recover damages. The first limitation—no recourse—provides that, in the event that the contractor suffers damages as a result of a breach of the construction agreement, the contractor's sole source of recovery is limited to the owner's interest in the real estate itself. That is, the contractor will not have recourse to the owner's additional assets to satisfy any judgment rendered against the owner.

The second limitation—non-liability—is advisable when the owner's business is a corporation, a limited liability company, or other similarly structured business. This provision allows that in the event the contractor suffers damages as a result of a breach, he cannot bring a claim against anyone other than the business entity itself, thus eliminating

potential claims directed against the officers, directors, shareholders, partners or members of the business.

Another important provision allows the owner the “right of set-off,” which essentially permits him to hold money due to the contractor to cover certain types of losses caused by the contractor. For example, if the owner receives a notice of a subcontractor lien claim during construction, this type of clause would allow him to withhold an amount equal to that claimed from future payments to the contractor. Payment would be released only after the claim is resolved. Similarly, if the owner discovers defective work during construction, he can use this type of provision to withhold money from the contractor until the defect has been corrected.

Lastly, a valuable contract clause that will further reduce the owner’s financial liability is the “contingent assignment of subcontracts” provision. This provision obligates the contractor to include in his subcontracts a clause stating that, upon notice from the owner, the subcontractor will agree to the assignment of the subcontract from the contractor to the owner. Typically, the assignment will be effective only after the termination of the agreement with the contractor and will only apply to those subcontracts that the owner wishes to accept.

Obviously, the owner’s right to undertake the assignment of subcontracts facilitates his ability to keep the project moving, even in a scenario where the contractor is in default. However, the key to this type of provision is to stipulate that the owner’s obligation to pay the subcontractor applies only to costs incurred after the assignment becomes effective. In other words, the contractor remains liable to the subcontractor for costs incurred prior to the assignment.

RISK ASSESSMENT DURING THE LIFE OF THE PROJECT

While a strong contract is essential to the success of any construction project, another important way to avoid litigation and reduce financial liability is to perform regularly scheduled risk assessments. The key here is vigilance, and there are several tools that owners can use to carefully monitor the process.

The first is the construction schedule. While most large contractors are well versed in the development and use of construction schedules, many mid-sized and smaller contractors are not. The schedule, however, is key to monitoring the health of the project. At a minimum, the contractor should develop a baseline schedule identifying the start

and completion of critical tasks, along what is commonly referred to as “the critical path.” Impacts to those activities, as well as to other events that have a direct effect on those critical tasks, should be shown on updated schedules issued monthly with each payment application.

Additionally, the contractor should provide “look-ahead” schedules during the month. These schedules depict what activities the contractor expects to undertake during the period covered by the look-ahead. With these tools, an owner can monitor the overall progress and determine whether the contractor is on schedule or whether he needs to take action to get back on track.

Another monitoring tool is the “schedule of values,” which is an itemized list that establishes the value of each part of the work for a stipulated price contract and for major lump-sum items in a unit price contract. Generally, the schedule of values is used by the contractor as the basis for preparing payment applications. However, the schedule of values can be used in combination with a detailed construction schedule, thereby allowing an owner to measure cash flow against the progress of the construction.

Using the schedule of values in conjunction with the construction schedule should allow the owner to determine whether the amount the contractor is expending exceeds the pace of the construction—an indication that the contractor underbid the work and may run out of money before the project is completed. Worse yet, it could be evidence that the contractor is diverting project funds. Regardless of the cause, the schedule of values can provide an owner with a warning sign that allows him to avoid or mitigate a potentially serious financial problem.

Regularly scheduled owner/architect/contractor (OAC) meetings are also useful for periodically monitoring the condition of the construction project. The purpose of the OAC meeting is for the owner, architect, and contractor to discuss relevant project issues, ideally on a monthly basis. For example, the architect typically shares his observations regarding the quality and progress of the work, as well as the status of his review of the shop drawing and any contractor-proposed change orders. Similarly, the contractor often discusses schedule status, upcoming activities requiring approval, anticipated changes in the work and other important issues affecting the work.

Generally, the construction contract requires the contractor to keep minutes of the meetings, which must be distributed to all attendees for review shortly after the meeting. Thorough meeting minutes allow the parties to track the progress

of the work and the resolution of critical issues affecting the work. They also provide the parties with a means of projecting future issues that may need to be addressed.

Another effective monitoring tool is the use of a contractually mandated “timeout.” As the name suggests, the timeout is a meeting of project personnel that occurs at various points when construction is, conceptually, stopped in order to address all known claims and other issues. If the timeout meeting is successful and problems are amicably resolved, the resolution is documented by change order and the project can move forward without a concern that those claims or issues will adversely impact the project in the future.

Such early resolution saves both money and time. If claims and issues cannot be resolved at the timeout meeting, at a minimum the parties are now on notice and are in a better position to mitigate future adverse impacts. For example, if a contractor delay claim cannot be resolved, the owner now

has notice of the claim and can work with the contractor to develop a schedule recovery plan before the issue becomes critical. Without the timeout, there is a good chance that an owner will not learn of a delay claim until it is too late to mitigate the impact.

THE REWARDS OF PRECAUTIONARY MEASURES

Regardless of the size and scope of a project, it is critical that all parties recognize the risks, manage expectations, and acknowledge the need to address potential problems contractually with the guidance of experienced legal counsel. Additionally, contractors, architects, owners and others involved in a project should seek professional insurance advice during the contractual process. These steps will go a long way towards helping all parties to avoid litigation, minimize their financial risk and ensure a project’s long-term success.